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Report on New York's Nonresident Income Allocation Requirements: Analysis and Recommendations

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New York State Bar Association Tax Section[1]
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I. Introduction

A. Executive Summary

On September 17, 2004 the New York State Department of Taxation and Finance (the "Department") issued new guidelines for use in personal income tax withholding audits. The new withholding guidelines are applicable when an employer has sufficient New York nexus and pays wages to a resident. They also apply to New York employers that pay New York source wages to a nonresident.

The withholding guidelines do not, however, discuss New York's sourcing rules.[2] Rather, they refer employers to New York's Nonresident Income Allocation Audit Guidelines (the "Allocation Guidelines"),[3] personal income tax regulations (the "Regulations"), and the applicable case law. Though the Department has periodically updated its Allocation Guidelines,

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1 The principal authors of this report were Paul R. Comeau and Jack Trachtenberg. Helpful comments were received from Kimberly S. Blanchard, Maria T. Jones, Carolyn Joy Lee, Arthur R. Rosen, and Michael Schler.

2 In January 2004, the Multistate Tax Matters Committee issued a report that reviewed, and recommended changes to, New York's income tax withholding requirements. Among the recommended changes were suggested clarifications with respect to the withholding and allocation requirements for certain categories of income, including deferred compensation. *See, e.g.*, New York State Bar Association Tax Section Report # 1047, "Report on New York's Personal Income Tax Withholding Requirements: Analysis and Recommendations" (January 13, 2004). While the Department's withholding guidelines ultimately adopted many of the suggestions contained in the January 2004 report, specific guidance regarding the allocation of nonresident income was not included. Instead, the withholding guidelines require New York employers to withhold on 100% of stock option and other deferred compensation unless certain requirements are met. *See* Peter L. Faber, "New York Withholding on Nonresident Employees—New Guidelines" *State Tax Notes* (Oct. 18, 2004).

3 Income Tax District Office Audit Manual, Section HN.8.1.12, State of New York Department of Taxation and Finance (Nov. 26, 1997).

some of the text is inconsistent with published regulations, and certain allocation concepts remain unclear, or are inconsistent with recent cases. This makes compliance by employers and taxpayers difficult.

This report reviews these inconsistencies and omissions, and recommends changes for administrative or legislative consideration. Though the report addresses many important aspects of New York's income allocation requirements, it focuses primarily on nonresident employees and deferred compensation. Part II of the report reviews the current case law, as well as the Regulations and Allocation Guidelines. In particular, the report analyzes several key administrative and state court decisions that have impacted the application of New York's Tax Law in the income allocation context, and notes several discrepancies that exist among the Regulations, Allocation Guidelines and case law. Since case law has recognized that Departmental guidelines, advisory opinions and technical service bureau memoranda do not have the force of regulations, the report offers suggestions for updating the Regulations, as well as the Allocation Guidelines. Finally, Part III of the report makes substantive recommendations for clarifying the rules applicable to determining the proper allocation of certain types of income.

B. New York's Income Allocation Rules

It is important to begin with a brief synopsis of New York's nonresident income allocation requirements. Under the United States Constitution, a state may not tax a nonresident's income unless it has some connection with the state.[4] Accordingly, New York's statute provides that a nonresident's income cannot be taxed unless it is derived from or connected to New York sources.[5] Generally, the New York source income of a nonresident individual includes all items of income, gain, loss and deduction entering into the taxpayer's federal adjusted gross income that are attributed to: (1) the ownership of any interest in real or tangible property located in New York; or (2) a business, trade, profession or occupation carried

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[4] *Shafer v. Carter*, 252 U.S. 37 (1920).

[5] N.Y. Tax Law § 601(e).

on in New York.[6] Income from items of intangible personal property (i.e., annuities, dividends, interest and gains from sales of intangibles) are not considered to be derived from New York sources unless the income is derived from property employed in a business, trade, profession or occupation carried on in New York.[7]

The implication for nonresident employees is clear. When compensation is earned for services performed wholly within New York, the nonresident's entire compensation is taxable by the State.[8] If compensation is paid for personal services rendered wholly outside of New York, the State may not tax any of the nonresident's income.[9] And when a nonresident performs services both within and without New York State, only a portion of the nonresident's income is subject to tax.[10] In the latter case, the Regulations provide that nonresidents must allocate their earnings to New York based upon a ratio that the number of days worked in New York bears to the total number of days worked both within and without the State.[11]

Failure to comply with New York's income allocation requirements can have significant consequences. In the case of a nonresident employee, the Department may assess additional tax, interest and penalties if it determines that an insufficient amount of income was allocated to New York.[12] Additionally, there are potential costs to New York employers, who may be held liable if they fail to withhold and remit the appropriate amount of personal income tax from the nonresident employee's wages.[13]

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6 *Id.* at §§ 631(a) & (b).

7 *Id.* at § 631(b)(2). A recent statutory change also treats certain sales of shares in a New York cooperative housing corporation as a taxable sale of real property, sourced to New York. *Id.* at § 631(b)(1)(E); TSB-M-04(5)I (Oct. 19, 2004).

8 20 NYCRR § 132.4(b).

9 *Id.*

10 *See Id.* at §§ 132.4(b) & 132.18(a).

11 *Id.* at § 132.18(a). There are exceptions for railroad workers, the military, commission salesmen and others. *See* 20 NYCRR § 132.11.

12 N.Y. Tax Law §§ 684 & 685.

13 *Id.* at §§ 671(a)(1) & 675. These liabilities extend not only to the employer, but also to certain "responsible" employees, owners and officers, all of whom may be held personally liable if the employer fails to properly withhold. *Id.* at § 685(g); *Matter of Oehler*, Tax App. Trib. (July 10, 2003).

C. Areas of Concern

Given these consequences, the New York income allocation rules should be clear. The sourcing and allocation rules seem straightforward, at least in the context of a typical nonresident whose compensation is limited to current wage income. In such a case, a relatively simple allocation is required based on the number of days the nonresident worked in New York, as compared to the total number of work days in the year.[14] Difficulties arise, however, when a nonresident receives other forms of compensation—especially deferred compensation—such as termination pay; annuities; pension and retirement income; and stock options. The treatment of non-compete payments is also unclear. As a result, it is often questionable whether compensation that is not in the form of wages, as well as other payments, are New York source income at all. And when a New York source can be ascertained, the proper methodology for allocating the income is sometimes uncertain.

We believe that the primary cause of these ambiguities is the absence of Regulations that fully develop these issues and reflect case law holdings regarding the taxability of various categories of income. In some cases, the Regulations (and Allocation Guidelines) are silent on the question of determining whether and how to allocate income to New York. In other instances, existing administrative guidance may be inconsistent, or at odds with, the case law. The resulting confusion leaves taxpayers unsure of how to meet their New York State income tax obligations; and no doubt also means that many taxpayers are either overpaying or underpaying their tax liabilities.

Part II of this report will discuss these issues as they relate to specific categories of income. In particular, the report will (consistent with the current case law, Regulations and Allocation Guidelines) address the allocation rules for non-compete payments, termination pay, annuities, and stock options. The "convenience of the employer doctrine" and the "reverse

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[14] New York's "convenience of the employer" doctrine, however, often creates some complications. The "convenience of the employer" doctrine treats services performed outside New York as New York services if the work was done outside the State because of employee convenience rather than employer necessity. *See* 20 NYCRR § 132.18(a).

convenience" tests will also be discussed. Part III of the report will then review several suggestions for updating and clarifying the Regulations and Allocation Guidelines.

II. Analysis

A. Non-Compete Payments

For many years, the Department maintained a position that monies received by a nonresident with respect to an agreement not to compete were taxable by New York if the non-compete agreement was entered into in conjunction with the sale of a New York business or with regard to New York services.[15] The Department's position changed, however, following the Tax Appeals Tribunal's decisions in *Matter of Haas*[16] and *Matter of Penchuk*.[17] In those cases, the Tribunal ruled that payments made under covenants not to compete, while ordinary income, were not taxable to nonresidents because they were not attributable to a business, trade, profession or occupation carried on in New York.

While it is now well accepted that non-compete payments are not taxable to nonresidents, the Regulations do not reflect this reality. In fact, they continue to state the Department's former audit position with respect to this issue, thus directly contradicting the governing case law:

> Where a pension or other retirement benefit does not constitute an annuity, it is compensation for personal services, and if the individual receiving it is a nonresident, it is taxable for New York State personal income tax purposes to the extent that the services were performed in New York State. The term "compensation for services" as used in the foregoing sentence includes, but is not limited to . . . *amounts received upon retirement under a covenant not to compete.*[18]

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15 *See Allocation Guidelines*, at ¶ .5E; *see also* 20 NYCRR § 132.4(d)(1).

16 *Matter of Haas*, Tax App. Trib. (Apr. 17, 1997).

17 *Matter of Penchuk*, Tax App. Trib. (Apr. 24, 1997).

18 20 NYCRR § 132.4(d)(1) (emphasis added).

In contrast to the Regulations, the Allocation Guidelines follow the basic *Haas* and *Penchuk* principle that non-compete payments made to nonresidents do not constitute New York source income:

> In the past, it was the Department's position that monies received by a nonresident with respect to an 'Agreement Not to Compete' . . . were taxable to New York. The Tribunal decisions . . . are responsible for reversing the Department's analysis.[19]

Moreover, neither the Regulations nor the Allocation Guidelines define what qualifies as an exempt non-compete payment, nor do they reflect the case law on this question. In *Matter of Colitti*,[20] the Tribunal was asked to address whether deferred stock option income that had been subject to forfeiture if the taxpayer competed with his former employer was New York source income when paid to a nonresident individual. While the taxpayer asserted that the income did not constitute New York source income because it was earned with respect to a covenant not to compete, the Department contended that the income was attributable to the taxpayer's former employment in New York. The Department relied upon the assertion that the taxpayer had originally been granted stock options in connection with his New York employment (i.e., as a reward for past New York services or as an incentive to remain employed), and had renegotiated his employment agreement by adding a non-competition and forfeiture clause. In the Department's view, the employee simply "upgraded" his existing employment agreement. Thus, the Department maintained that the option income he received was paid in connection with the taxpayer's New York employment.

The Tribunal disagreed. It ruled that the taxpayer's stock option income was not subject to New York State income tax because the taxpayer's right to the income "***depended on*** . . . not accepting employment with a competitor."[21] The Tribunal determined that this contingency existed on the basis that if the taxpayer had competed with his former employer, "he would have been in breach of his [retirement] agreement and would not have earned the

19 *Allocation Guidelines*, at ¶ .5E.

20 *Matter of Colitti*, Tax App. Trib. (June 19, 2003).

21 *Id.* (emphasis added).

compensation which [was] sought to be taxed."[22] The Tribunal rejected the argument that the taxpayer had upgraded his employment agreement, ruling instead that the taxpayer had forfeited his previous stock option rights in favor of new rights that were contingent upon the non-compete agreement.

Some practitioners believe that *Colitti* has altered the landscape of New York's income tax law with respect to the taxation of deferred compensation.[23] Based on a plain reading of the Tribunal's decision, it would appear that all deferred bonus, stock option and other payments that are subject to forfeiture or repayment if the employee violates a non-compete agreement, are exempt from New York's income tax if paid to a nonresident. Others disagree, and point to the recent decision in *Matter of Clapes*[24] for the proposition that the mere presence of a non-compete contingency is not enough to exempt income from taxation in New York.

In *Clapes*, the taxpayer received income from options that were awarded to him during his employment in New York. Before exercising the options, the taxpayer entered into an early retirement agreement with his employer. The agreement provided that the taxpayer's stock option grants would remain in effect and would be fully exercisable after his termination, but also provided that he could not compete with his employer for three years after leaving the company. The agreement did not contain a forfeiture clause (i.e., the taxpayer would not lose his rights to the options or the option income if he competed with his former employer).

The taxpayer argued that, pursuant to *Colitti*, the income he received from these stock options was not taxable by New York because he received the income in exchange for a promise not to compete. The Tribunal disagreed and distinguished *Colitti* on the basis that the taxpayer there had given up his rights to stock options that had been acquired in connection with his New York employment, in favor of new rights to stock options under the terms of an employment termination agreement that contained a non-compete clause.[25] According to the

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22 *Id.*

23 *See, e.g.*, New York State Bar Association Tax Section Report # 1047, "Report on New York's Personal Income Tax Withholding Requirements: Analysis and Recommendations" (January 13, 2004).

24 *Matter of Clapes*, Tax App. Trib. (Jan. 6, 2005).

25 *Id.*

Tribunal, the taxpayer in *Clapes* did not do this. Rather, his stock option awards, which were derived from his New York employment, were to remain in effect under the early retirement agreement.

The exact meaning of *Colitti* and *Clapes* is unclear. But regardless of how broadly or narrowly one construes these cases, it is likely that they have impacted the allocation rules with respect to deferred compensation earned by nonresidents. Yet, both the Regulations and Allocation Guidelines are silent on the subject. The Allocation Guidelines (but not the Regulations) address the general question of how stock options are taxed, but do not describe the impact of a forfeiture provision tied to competition. This makes it extremely difficult for both employers and employees to determine their ultimate responsibilities with respect to withholding and reporting income to New York. Moreover, it appears that auditors are applying the general stock option allocation rules to impose taxes on option income, even when non-competition clauses are present. Consequently, employers often withhold on the same basis. This happened in *Colitti*, where the employer withheld full New York taxes on the option income in question. Mr. Colitti sought a refund, which was denied by the Department, but granted by the Tribunal. Thus, the withholding by the employer was *not* required, since the income was not taxable in New York. Absent clarification on this subject, employers can be expected to withhold on a conservative basis, and many nonresident employees will not seek a refund because they will assume that the withholding was correct.

B. Termination Pay

Sometimes, it is clear that payments received by a nonresident taxpayer upon termination of employment constitute consideration for past services. These payments, which may take the form of wage continuation payments, deferred compensation, severance pay, etc., generally constitute New York source income if paid for personal services previously rendered in New York State. The question becomes how such income should be allocated where the services were rendered both within and without the State.

According to the Regulations, termination pay is generally allocable to New York State based on New York compensation over total compensation for the year of retirement plus the preceding three years:

> Where the employee's services were performed partly within and partly without New York State, the amount includible in the individual's New York adjusted gross income is the proportion of the amount included in the individual's Federal adjusted gross income which the total compensation, received from the employer for the services performed in New York State during a period consisting of the portion of the taxable year prior to retirement and the three taxable years immediately preceding retirement, bears to the total compensation received from the employer during such period for services performed both within and without New York State.[26]

The regulations contain no other discussion of how to treat termination pay, thereby appearing to assume that such income is always subject to a New York allocation.

Yet, the case law clearly establishes that, in some cases, termination pay is not subject to New York income tax at all. In *Matter of McSpadden*,[27] the Tribunal held that termination pay granted to a nonresident employee does not constitute New York source income if it was paid to buy out the remainder of the employee's employment contract. For example, if a nonresident employee with a five-year employment contract is terminated after one year and receives a lump sum as consideration for the cancellation of the balance the employment contract, the lump sum is not taxable. According to the Tribunal, the lump sum payment is to be treated as a payment for an intangible (i.e., the remaining term value of the employment contract).

Subsequent case law has clarified what constitutes a non-taxable "buy out" payment. For instance, in *Matter of Brophy*, the Tribunal ruled that the *McSpadden* rule does not

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[26] 20 NYCRR § 132.20. Note that unlike current compensation and stock options, which are allocated based on New York work *days* over total work *days*, severance is allocated based on New York *compensation* over total *compensation*. Further, the multi-year period for stock options (*see* Part II, Section D, *infra*) is measured from the date of grant to the date of exercise, which could easily exceed the four year period used to allocate severance pay.

[27] *Matter of McSpadden*, Tax App. Trib. (Sept. 15, 1994).

apply unless the taxpayer can prove that a formal employment agreement (i.e., a contractual right to employment) existed with his or her employer.[28] According to *Brophy*, a formal agreement can be found based on an understanding of the parties, even if there is no written employment contract. *Matter of Davis*[29] provides a further refinement, indicating that once a formal employment agreement has been found to exist, a separate written termination agreement is not required in order for the *McSpadden* rule to apply. The Regulations do not address these clarifying case law doctrines.

McSpadden and its progeny have established that certain types of termination pay are not subject to New York's income tax. The Allocation Guidelines reflect an awareness of *McSpadden*, but auditors seem reluctant to apply the *McSpadden* doctrine, and employers are confused by inconsistent regulations. In the absence of clear guidance in the Allocation Guidelines and Regulations regarding these rules, taxpayers may unknowingly allocate exempt income to New York, or may fail to allocate to New York income that is properly subject to tax. Moreover, even if a particular taxpayer is aware of the case law, questions still arise as to whether the Department will consider a particular payment to be a "buy out" under *McSpadden*. Again, this makes it difficult for both employers and employees to determine their ultimate responsibilities with respect to withholding and reporting income to New York.

The Regulation discussed above (i.e., section 132.20) compares New York compensation with total compensation for the year of retirement and the preceeding four years, but in all other areas the Regulations call for allocations based on a comparison of New York and total work days. The two approaches can have dramatically different results. Assume that options are granted January 1, 2000 and exercised December 31, 2003, when the employee retires. Assume a lump sum payment of $2 million, allocable to either options or termination pay, and that prior year compensation and work days were as follows: $1 million of income allocated entirely to New Jersey in 2000, and $100,000 per year in 2001, 2002 and 2003, all of which was allocated to New York. Finally, assume the same number of work days each year. If

28 *Matter of Brophy*, Tax App. Trib. (Dec. 7, 1995).

29 *Matter of Davis*, Admin. Law Judge (Jan. 14, 1999). Although ALJ cases are not binding on the Department, they can be instructive and may indicate current thinking on the law. They frequently contain an analysis or approach that is followed by the Department.

the income in question is stock option income, 75% of the $2 million would be allocated to New York, based on 75% New York work days. If the income was termination pay, only 23% would be allocated to New York based on a comparison of New York and total compensation over the same four year period. This may benefit some taxpayers and hurt others, but it raises a question regarding the use of different allocation methods in these situations.

C. Annuities

The Regulations state that pensions in excess of $20,000 per year are taxable in New York when paid to nonresidents if they do not qualify as an annuity and are attributable to services performed by the nonresident in the State:[30]

> Where a pension or other retirement benefit does not constitute an annuity, it is compensation for personal services, and if the individual receiving it is a nonresident, it is taxable for New York State personal income tax purposes to the extent that the services were performed in New York State.[31]

According to the Regulations, a pension or other retirement income will not qualify as a tax-exempt annuity unless several requirements are met. First, the pension must be paid in money only.[32] Second, it must be payable at regular intervals for the life of the recipient, or over a period that is not less than one-half of the recipient's life expectancy.[33] Third, the pension must be payable at a uniform rate, or at a rate that varies in conjunction with certain specified criteria.[34] Finally, a written instrument must exist to prove that the recipient has a right

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30 N.Y. Tax Law § 612(c).

31 20 NYCRR § 132.4(d)(1).

32 *Id.* at § 132.4(d)(2)(i).

33 *Id.* at § 132.4(d)(2)(ii).

34 *Id.* at § 132.4(d)(2)(iii).

to receive the pension.[35] Under the Regulations, if any of these requirements are not met, the nonresident's pension income must be allocated to New York State.

These regulations date back to 1992, and fail to address federal legislation that took effect in 1996. Specifically, Public Law § 104-95 prohibits states from taxing a nonresident's "retirement income," regardless of its source.[36] The federal statute defines "retirement income" to include most qualified and tax-favored plans, as well as other arrangements, such as: (1) plans qualified under Internal Revenue Code (the "Code") § 401, including certain qualified pension, profit-sharing, stock bonus and annuity plans; (2) plans qualified under Code § 408(k), which are typically referred to as Simplified Employee Plans; (3) annuities as defined under Code §§ 403(a) and (b); (4) individual retirement annuities under Code §§ 408(a) and (b); (5) Code § 457 plans for state and local governments and tax-exempt organizations; (6) government plans covered under Code § 414; (7) certain trusts covered under Code § 501(c)(18); and (8) certain income from plans described in Code § 3121(v)(2)(c).[37] Under P.L. § 104-95, such retirement income is exempt from state taxation without regard to the criteria currently set forth in the Regulations.[38] As a result, and contrary to the text of the existing Regulations, New York is prohibited from taxing many types of nonresident retirement income, even if the income does not constitute an annuity payment under the Tax Law.

To date, the impact of P.L. § 104-95 has been addressed only in the Allocation Guidelines, as well as in a series of advisory opinions issued by the Department.[39]

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35 *Id.* at § 132.4(d)(2)(iv). Other specified requirements must be met where the pension is paid to a nonresident beneficiary or deceased employee. *Id.* at § 132.4(d)(2)(v).

36 4 U.S.C. § 114.

37 *Id.*

38 *Id.*

39 *See, e.g.*, TSB-A-01(2)I (May 23, 2001).

D. Stock Options [40]

In *Michaelsen v. New York State Tax Comm'n*,[41] the Court of Appeals established that a nonresident employee who receives incentive stock options, and who exercises the options and subsequently sells the stock at a gain, is not taxable on gains due to appreciation after the exercise date. The "compensable period" ends on the date the option is exercised. Gains after that date constitute investment income that is not taxable as compensation for services. The Department has interpreted *Michaelsen* as a grant of permission to tax the "compensable portion"—i.e., the difference between the market value of the stock at the time the option was exercised and the market value of the stock at the time the option was granted.

While *Michaelsen* addressed the compensable portion of a nonresident's stock option income, it did not address how that compensation should be allocated if the employee performed services both within and without New York State.[42] Prior to *Michaelsen*, the Department took the position that stock option income should be allocated on the same basis as was used for allocating other compensation for the tax year in which the option was exercised.[43] The Department has since reversed that position, maintaining instead that "any allocation must be based on the allocation applicable to regular (non-option) compensation received by the employee during the compensable period."[44] In other words, the nonresident must allocate the compensable component of the stock option income based on a ratio, the numerator of which is the total days worked by the employee in New York State during the grant-to-exercise period,

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40 The allocation methodologies discussed in this section apply to statutory stock options, restricted stock plans, stock appreciation rights and non-statutory stock options.

41 67 N.Y.2d 579 (1986).

42 *Id.*; *see* TSB-M-95(3)I (Nov. 21, 1995) ("Although *Michaelsen* resolved the issue concerning the total compensation that may be includable in the New York source income of a nonresident, the court did not address how the total amount should be allocated for New York purposes if the employee performs (or performed) services both inside and outside the state.).

43 *See Matter of Rawl*, Admin. Law Judge (Dec. 10, 1998).

44 TSB-M-95(3)I. There is a question regarding the Department's ability to reverse a rule with a TSB-M. *See Matter of Rawl*, Admin. Law Judge (Dec. 10, 1998), in which the taxpayer argued that a rule can be changed by a statute or regulation, but not by a TSB-M.

and the denominator of which is the total number of days worked by the employee both within and without New York State during the same period.[45]

The Department bases its use of the grant-to-exercise methodology on Regulation §§ 132.4(c) and 132.18. These regulatory provisions, however, provide only that: (1) deferred compensation is allocable to New York if paid for services rendered in the State; and (2) that compensation for services rendered partly in New York is allocable to the State based on a proportion that the number of days worked in New York bears to the number of days worked everywhere. Neither provision calls for a multi-year allocation or addresses the taxation of deferred compensation or stock option income.[46] In fact, the cited Regulations are entirely silent on these subjects.

The only guidance put forth by the Department regarding the taxation of stock option income are the Allocation Guidelines and Technical Services Bureau Memorandum 95(3)I (the "TSB-M"). Both recount the holding of *Michaelsen,* recognize that the Court of Appeals failed to address the allocation methodology applicable to stock option income, and assert the grant-to-exercise methodology discussed above.

The Regulations and the TSB-M, however, are at odds with a host of case law determinations. In *Matter of Rawl*—a case that was decided after the Regulations were promulgated and the TSB-M issued—the Administrative Law Judge rejected the multiyear grant-to-exercise approach and found for an allocation of option income based solely on allocation factors in the year of exercise.[47] The State Tax Commission's decision in *Matter of Tobin* also

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[45] *Id*. If the option was granted in 1980, but exercised in 2005, New York would expect an allocation based on a comparison of New York to total work days from the 1980 grant through the 2005 exercise date, a 25 year allocation period!

[46] The only multi-year allocation provided for in the Regulations is for termination pay, described earlier, which calls for an allocation based on New York and total compensation (not work days) for the year of retirement plus the preceding three years. 20 NYCRR § 132.20.

[47] *Matter of Rawl*, Admin. Law Judge (Dec. 10, 1998). The ALJ in *Rawl* supported his determination by citing to *Matter of Christensen,* State Tax Comm'n (Aug. 22, 1977). In that case, an employee worked many years abroad, but worked in New York during the year of exercise, and factors for that year were used to set the allocation. *Rawl* was an ALJ case, and *Christensen* a Tax Commission decision. Again, it is recognized that these cases are not binding on the Department, but are instructive and may indicate current thinking on the law.

endorses a year of exercise methodology.[48] And in *Matter of Sadik-Kahn*,[49] the Administrative Law Judge determined that the taxpayer's stock option income should be allocated based upon the allocation factors in the year of retirement plus the preceding three years. Recently, in *Matter of Stuckless*,[50] an Administrative Law Judge upheld the validity of the grant-to-exercise methodology.

Given this confusion, a reasonable taxpayer could read the Regulations and the case law to conclude that stock option income should be allocated based on the number of days worked in New York during the year of exercise, even though that does not appear to be the Department's current position. Specifically, the Regulations state that where employers pay supplemental wages, such as bonuses, commissions or sales awards, at the same time as regular wages, the withholding "should be determined as if the total of the supplemental and the regular wages were a single wage payment for the regular payroll period."[51] And where paid at a different time, an employer should add the supplemental wages to the regular wages for either the current payroll period or the last preceding payroll period within the same calendar year.[52] Based on these provisions, an employee and employer could reasonably conclude that stock option income is to be treated as "supplemental income" allocable as a "single wage" payment based on factors for the year of receipt.

E. The "Convenience of the Employer" Doctrine

For allocation purposes, New York applies a convenience versus necessity test in determining the number of days worked outside of the State.[53] This test, commonly referred to

48 *Matter of Tobin*, TSB-H-83(43)I, State Tax Comm'n (Jan. 24, 1983).

49 *Matter of Sadik-Kahn*, Admin. Law Judge (July 19, 1990).

50 *Matter of Stuckless*, Admin. Law Judge (July 8, 2004).

51 20 NYCRR § 171.4(b)(1).

52 *Id*.

53 *Id*. at § 132.18.

as the "convenience of the employer" doctrine, generally requires nonresidents who work for a New York employer to treat days worked outside of the state as New York work days if the taxpayer worked outside of New York for his or her convenience. The classic example, and much of the case law, treats days worked at an out-of-state home as New York days for allocation purposes. An exception applies when the employer requires the employee to perform the services out of state, and the nature of those services are such that they cannot be performed in New York. The convenience of the employer doctrine is reflected in both the Regulations and the Allocation Guidelines.[54]

While the Regulations and Allocation Guidelines make it obvious that New York will consider out-of-state "convenience days" to be New York work days for allocation purposes, there is less certainty regarding how the State will handle the reverse situation. Specifically, it is unclear how New York would source payments received for services performed by a nonresident who is regularly employed outside of New York if he or she performed some services from, for example, a vacation home located in New York.

In *Matter of Zelinsky*,[55] the Tribunal indicated that a "reverse convenience" test would apply in such circumstances. Specifically, the Tribunal intimated that New York would consider the New York "convenience days" (i.e., those worked at the New York vacation home) to be Connecticut work days:

> [W]here a New York resident is employed in Connecticut but chooses to work at home in New York on certain days, New York would . . . source the income on the 'choice to work at home' days as derived from Connecticut.[56]

Neither the Regulations nor the Guidelines currently recognize the existence of this "reverse convenience" doctrine.

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54 *Id.*; *Allocation Guidelines*, at ¶.7C. The New York State Court of Appeals has recently upheld the constitutionality of the "convenience of the employer" doctrine. *See Matter of Zelinsky*, 1 N.Y.3d 85, 769 N.Y.S.2d 464 (2003); *Matter of Huckaby*, ___ N.Y.3d ___ (2005).

55 *Matter of Zelinsky*, Tax App. Trib. (Nov. 21, 2001).

56 *Id.*

VI. Recommendations

Most of the relevant Regulations were last revised in 1995 or earlier. The Allocation Guidelines were last updated in May 1998. Accordingly, it is entirely understandable that they do not reflect many of the case law developments that have been discussed in this report. Nonetheless, in New York's sophisticated business environment, where non-compete payments, termination pay, annuities, stock options and similar financial arrangements are common, the absence of clear and comprehensive guidance on these subjects frequently leads to confusion, and to circumstances in which similar fact patterns are not (as a practical matter) accorded similar treatment. Therefore, it is important that New York clarify its rules regarding the allocation of these common forms of income. Employers must be able to properly determine their withholding obligations, and employees must have the knowledge necessary to properly report their income to the State. This is especially true where the timely filing and payment of New York taxes will entitle nonresident employees to home-state tax credits that may become time-barred if the employee's responsibility is not known until a future year.

In light of the foregoing, we recommend the following with respect to the specific categories of income discussed in this report:

Non-Compete Payments. The holdings of *Haas* and *Penchuk*—that non-compete payments are not taxable to nonresidents—represent binding interpretations of Tax Law § 631(b)(1)(B). As such, the cases currently constitute precedent that must be followed by the Department. Moreover, the Department has acquiesced to both decisions, stating in its Allocation Guidelines that "[b]ased on the precedent that has been set by these two recent Tribunal decisions, it appears we can no longer make a strong argument for payments received by nonresidents in connection with a covenant not to compete."[57] Consequently, it is recommended that the Regulations and Allocation Guidelines be brought into congruence, so as to definitively state that non-compete payments do not constitute New York source income.

[57] *Allocation Guidelines*, at ¶ .5E.

Additional guidance is also necessary to assist taxpayers in determining whether an item of income represents a non-compete payment in the first place. As discussed above, there is a question as to whether deferred bonus, stock option and other payments are exempt simply because they are paid pursuant to an agreement that contains forfeiture provisions if there is a violation of a non-compete clause. Certainly, *Colitti* and *Clapes* may be read broadly or narrowly, depending on one's view of the cases. Accordingly, it is recommended that the Regulations and Allocation Guidelines be updated and revised to identify rules for determining when the presence of a non-compete contingency will render a particular payment exempt. The Tax Section recognizes the difficult questions raised by *Colitti* and *Clapes*, and would welcome the opportunity to work with the Department on providing clear and comprehensive guidance.

Termination Pay. As in the case of non-compete payments, the Tribunal's decisions regarding termination pay are binding on the Department. Accordingly, the Department must abide by the decision in *McSpadden* that amounts paid to buy out the remainder of an employee's employment contract represents nontaxable payments for an item of intangible personal property. The Allocation Guidelines discuss *McSpadden* at length, and instruct auditors to make determinations in light of its holding. Accordingly, it is recommended that the Regulations be updated and revised in accordance with *McSpadden* and its progeny to account for the proper treatment of income earned in exchange for the relinquishment of a right to future employment. Specific criteria should be provided to assist taxpayers in determining whether a particular payment has been received as a "buy out" of an existing employment right.

Furthermore, in the interest of simplicity, we recommend that taxable severance and stock option income should both be allocated in the same way. Since the Regulations already contain a four year rule for termination pay, we recommend an allocation based on a four year period, which for taxable termination pay, would be the year of retirement and the prior three years. The current Regulation for termination pay compares compensation rather than days worked over the multi-year period, while stock option and most other multi-year compensation is allocated based on a comparison of work days (not compensation) for the multi-year period. We believe that a uniform rule is desirable, based on either days or compensation, and we recommend consideration of a uniform rule.

Annuities. As discussed in this report, the Regulations do not currently reflect the impact of P.L. § 104-95 on the taxability of a nonresident's "retirement income." Accordingly, it is recommended that the Regulations be updated and revised to reflect the exemptions provided for retirement income under P.L. § 104-95.

Stock Options. As indicated by the case law discussed above, there does not appear to be a single "correct" method for allocating stock option income earned by nonresidents. The year of exercise, grant-to-exercise and four-year allocation methodologies are all—arguably—technically acceptable. However, it is suggested that the best approach may be to adopt a modified four-year allocation formula for stock option income. In particular, it is recommended that stock option income be allocated based on the number of days that the nonresident worked in New York divided by the total number of days worked both within and without the state during the four year period ending with the year or receipt or the retirement year, if earlier. We believe that such a methodology would provide for a more manageable allocation period, and would (by looking to days instead of compensation) result in an easier to follow and more accurate allocation formula.

If, however, the Department wishes to continue its assertion of the grant-to-exercise methodology, it should do so via properly disseminated and duly promulgated regulations. The 1995 TSB-M, which is the only Departmental guidance that puts forth the grant-to-exercise methodology, represents a reversal of the Department's prior audit policy, which should not be accomplished through a TSB-M. If a grant-to-exercise regulation is adopted, it should contain a discussion of the rules laid out in *Michaelsen*, and should provide guidance on how to allocate stock option income earned by a nonresident.

Convenience of the Employer Doctrine. As discussed above, the Regulations and the Guidelines do not discuss whether New York will apply the "reverse convenience" test. The recent Tribunal decision in *Zelinsky*, however, indicates that such a doctrine should apply as a matter of equity and consistency. We agree, and therefore recommend that the Regulations and Allocation Guidelines be updated to reflect the existence of a "reverse convenience" doctrine. If New York does not wish to adopt such a rule, the Regulations and Allocation Guidelines should be revised to specifically note the Department's disagreement with the Tribunal's analysis.